CHAPTER 8

MEASURE INCOME PROPERLY

Significant strides were made in the Deficit Reduction Act of 1984 toward accurately reflecting the "time value of money" in measuring taxable income. This Chapter discusses proposals that would continue these improvements. Areas addressed in the 1984 legislation were generally not reevaluated.

The Administration proposals would require production costs to be capitalized on a more comprehensive basis, providing a more accurate matching of income and expenses. Accounting methods that mismeasure income, such as the cash method of accounting and the installment method, would be limited. Finally, the deductions for additions to bad debt reserves and to reserves for mining and solid waste reclamation and closing costs would be repealed.

REVISE ACCOUNTING RULES FOR PRODUCTION COSTS

General Explanation

Chapter 8.01

Current Law

In General

Where a taxpayer produces inventory or property that is not sold during the current year, the costs of production generally may not be currently deducted. Rather, these costs must be added to the taxpayer's basis in the property to which they relate. If the product is sold, the capitalized costs are recovered against the selling price. If the product is a durable good that is used in the taxpayer's business, the costs are recoverable as depreciation, amortization, or depletion deductions.

The general principle that production costs must be capitalized is not uniformly applied in all contexts. In some cases, production costs may be currently deducted. In others, where current tax accounting rules require production costs to be capitalized, the costs included within the definition of "production costs" vary substantially depending on the type of property produced and the method of production.

Production Costs Other than Interest

Inventories. In accounting for inventories of manufacturers or producers, costs must be collected according to the full absorption method of inventory accounting. All direct costs and certain indirect costs must be capitalized. Indirect costs that are not required to be included in inventoriable costs include, for example: depreciation and amortization reported for Federal income tax purposes in excess of depreciation reported in the taxpayer's financial reports, and general and administrative expenses incident to and necessary for the taxpayer's activities as a whole.

The treatment of certain other indirect costs varies depending on how such costs are treated in the taxpayer's financial reports ("financial-conformity indirect costs"). These costs must be capitalized only if the taxpayer capitalizes them in its financial reports. Included in this category of indirect costs are: taxes, depreciation and cost depletion attributable to assets incident to and necessary for production; pension and profit-sharing contributions and other employee benefits; costs attributable to rework labor, scrap and spoilage; factory administrative expenses; salaries paid to officers attributable to services performed incident to and necessary for production; and insurance costs incident to and necessary for production.

Long-term contracts. Long-term contracts are building, installation, construction, or manufacturing contracts that are not completed within the taxable year in which they are entered into. Taxpayers using the completed-contract method of accounting for long-term contracts may not deduct contract costs until the contract is completed and income is reported. The rules for determining which costs must be treated as contract costs differ from the full absorption costing rules applicable to inventory. In addition, different rules apply depending on the duration of the contract.

For many long-term contracts the costs that must be capitalized generally track the full absorption regulations as they apply to a manufacturer that capitalizes in its financial reports the financial-conformity indirect costs. Differences are as follows: pension contributions and other employee benefits need not be capitalized; costs attributable to strikes, rework labor, scrap, and spoilage need not be capitalized; and research and experimental expenses directly attributable to particular contracts must be capitalized.

In the case of "extended-period long-term contracts," proposed regulations provide that taxpayers must capitalize certain additional long-term contract costs. With certain exceptions, extended-period long-term contracts are contracts that take more than two years to complete. The additional costs that must be capitalized include:

- all depreciation, amortization, and cost recovery allowances on equipment and facilities used in the performance of particular extended-period long-term contracts (tax depreciation in excess of depreciation reported on financial statements need not be capitalized in the case of non-extended-period contracts);
- depletion (whether or not in excess of cost) incurred in the performance of particular extended-period contracts;
- pension contributions and other employee benefits;
- rework labor, scrap, and spoilage incurred in the performance of particular extended-period contracts;
- expenses of successful bids; and
- certain direct and indirect costs incurred by any administrative, service, or support function or department to the extent allocable to particular extended-period contracts.

Proposed regulations set forth detailed rules for allocating administrative, service, and support costs to particular extended-period long-term contracts. The general test is whether a particular function or department of the taxpayer provides benefits to the extended-period long-term contracts, or merely benefits the overall management or policy guidance functions of the taxpayer.

Self-constructed assets. The costs of constructing or improving property having a useful life substantially beyond the taxable year must be capitalized and added to the basis of the property constructed. Existing regulations do not spell out which costs are to be capitalized when the taxpayer constructs property for its own use. The Supreme Court has held that depreciation on equipment used in such construction must be capitalized, and other courts have required certain indirect expenses, such as vacation pay, payroll taxes, certain fringe benefits, and certain overhead costs to be capitalized. Although administrative and judicial interpretations provide some guidelines, it is not clear in many self-construction cases whether particular costs may be deducted or must be capitalized.

Farming. Most farmers are not required to keep inventories for tax purposes, and thus do not capitalize the costs of producing crops. All of these costs may be deducted in the year when paid. The same is generally true of the costs of raising long-lived plants and animals, such as fruit and nut trees or breeding livestock. The costs of acquiring the seedlings or immature animals generally may not be deducted, however. The rule allowing a current deduction for most production costs originated from a concern that undue recordkeeping burdens not be imposed on farmers.

Some farmers are required to capitalize certain production costs. Under section 447, certain farming corporations must use an accrual method and inventory accounting in computing income, and accordingly are effectively denied a current deduction for production costs to the extent reflected in increased inventory. Section 447 does not apply to S corporations, corporations that are 50-percent owned by one family, or corporations with gross receipts of $1,000,000 or less. The provision is also inapplicable to certain corporations that were closely held to a requisite extent on October 4, 1976, and were engaged in farming on that date. In addition to requiring use of the accrual method and inventory accounting for tax purposes, section 447 requires the preproductive period expenses of raising long-lived plants and livestock to be capitalized. Preproductive period expenses are defined as any amount (other than interest and taxes) which is attributable to the preproductive period of crops, animals, or any other property having a crop or yield. In the case of property having a useful life of more than one year that will have more than one crop or yield, the preproductive period is the period before the disposition of the first marketable crop or yield. In the case of any other property having a crop or yield, the preproductive period is the period before the property is disposed of.

Farming syndicates engaged in developing a grove, orchard, or vineyard in which fruit or nuts are grown must capitalize the expenses of these activities under section 278(b). Instead of including the entire period before the disposition of the first marketable crop, the period during which expenses must be capitalized includes only the period before the first taxable year in which the grove, orchard, or

vineyard bears a crop or yield in commercial quantities. Under proposed regulations, farming syndicates need not capitalize the following expenses: real estate taxes, interest, soil and water conservation expenditures that are deductible under section 175, and expenditures for clearing land allowable as a deduction under section 182.

Under section 278(a), expenses attributable to the development of any citrus or almond grove incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted must be capitalized. This provision is not restricted to farming syndicates. As under section 278(b), interest, taxes, soil and water conservation expenditures, and expenditures for clearing land need not be capitalized.

Timber. Some costs of producing timber are not deductible when paid or incurred, but may be recovered only when the timber is sold. These include planting costs (site preparation, seed or seedlings, labor and tool expenses, and depreciation on equipment) and costs of silvicultural practices incurred before the seedlings are established. All other production costs may be currently deducted, including carrying costs (such as property taxes), costs of silvicultural practices after establishment of the seedlings, costs of disease and pest control, fire protection expenses, insurance, and management costs (including labor and professional costs, costs of materials and supplies, and costs of timber cruises for management purposes, but not timber cruises in connection with the purchase of timber).

Capitalization of Construction-Period Interest

Real property construction-period interest and taxes may not be currently deducted, but must be amortized over ten years. If the property is sold before all the expenses are recovered, the unrecovered expenses are added to basis in determining gain on the sale. The provision does not apply to low-income housing, or to property that cannot reasonably be expected to be held in a trade or business or in an activity conducted for profit. Construction-period interest includes any interest expense that could have been avoided if construction expenditures had instead been used to repay indebtedness.

Construction-period interest relating to personal property may be deducted currently.

Reasons for Change

Current tax rules do not always match taxable receipts and deductions relating to production activities. This failure to match is of particular concern in the case of production that extends beyond one taxable year ("multiperiod production"), and becomes more significant with longer production periods. The mismatching of

receipts and expenses permits deductions from these activities to offset income from other activities. A large number of tax shelters involve the so-called "natural deferral" industries, such as timber, extractive industries and vineyards.

Production expenses that relate to income to be produced in future periods should be matched with that income by capitalizing the production costs. Current tax accounting rules do not require comprehensive capitalization of costs. Most importantly, the current rules do not require the capitalization of interest paid with respect to the cost of carrying multiperiod production investments to completion. When these costs are not capitalized, the producer is able to shelter other income by deducting these costs, thus enjoying tax deferral.

Different rules regarding which production expenses must be capitalized apply to different types of activities. Long-term contracts, self-constructed assets, and inventories all have different capitalization rules. Replacement of the several different income tax accounting rules by uniform rules would make the income tax system more neutral and fairer.

Uniform capitalization rules would also eliminate tax distortions across activities. The current rules encourage a business to construct its own assets rather than to purchase them even when it is not the most efficient producer. The advantage given self-constructed assets is evidenced by comparing the basis of property in the hands of one who purchases with that of one who self-constructs. A seller prices goods by reference to all costs, including those deducted for tax purposes, plus a reasonable profit. The tax basis of a purchased asset, therefore, includes all costs of production, both direct and indirect, and these costs are recoverable by the purchaser only when sold or through depreciation, amortization, or depletion allowances. In contrast, the tax basis of a self-constructed asset includes only certain direct costs and perhaps a few indirect costs, while all other costs are deducted currently.

In addition to distorting investment decisions, the present rules cause serious unfairness. The benefits of tax deferral tend to be reflected in the prices of the products produced by multiperiod processes. Because the value of the tax deferral is related to the marginal tax rate of the investor, the attractiveness of these activities as tax shelters crowds out low-bracket individuals, as "shelter investors" bid-up the costs. Low tax rate individuals find they cannot earn a market after-tax rate of return at the price established by "shelter investors."

In sum, present law applies incomplete capitalization rules nonuniformly to different types of multiperiod production and applies rules that vary according to whether the output is sold or used in the producer's own business. These rules violate the principle of tax neutrality and should be modified.

Proposal

Capitalization of production costs other than interest. Uniform rules for capitalizing production costs would apply in all cases where the costs of producing or constructing real or personal property must be capitalized. The following types of production activities would be subject to the uniform capitalization rules:

- the production or manufacture of goods to be held in inventory or for sale to customers in the ordinary course of business;
- production under a long-term contract;
- the construction or other production of real or tangible personal property (including improvements to property) having a useful life beyond the taxable year, whether such property is to be used in the taxpayer's business or held for investment ("self-constructed assets"); and
- the growing of timber.

Special rules, described below, would apply to Federal government and cost-plus contracts and to farming. Current-law rules allowing expensing of certain development costs of oil and gas and other mineral property would remain unchanged; indirect costs would, however, be allocated to such development costs according to the rules set forth below.

The expenses of a particular production activity that would have to be capitalized would generally include all direct and indirect costs of production, as set forth in the rules applicable to extended-period long-term contracts, described in detail above. Major expenses that would not have to be capitalized as production costs include:

- marketing, selling, and advertising expenses;
- research and development expenses unrelated to particular production activities;
- expenses of unsuccessful bids and proposals; and
- general and administrative expenses other than those properly allocable to particular production activities.

General and administrative expenses attributable to certain cost-plus and Federal government contracts would have to be capitalized. This requirement would apply to all cost-plus contracts (i.e. not just contracts with Federal agencies) and to contracts with Federal agencies where the contractor is required by statute or regulation to submit certified cost data in connection with the award

of the contract. Federal statutes generally require certified cost data to be submitted in connection with contracts the price of which is expected to exceed $100,000. This rule does not apply where the contract is awarded on the basis of sealed bids; where there is adequate price competition; or where the price is an established catalog or market price or is set by law. In the case of cost-plus contracts, only those types of general and administrative expenses that are reimbursed under the contract would have to be capitalized. General and administrative expenses required to be capitalized would not include marketing, selling, and advertising expenses, research and development expenses unrelated to particular contracts, or expenses of unsuccessful bids and proposals.

Special rules would apply to farmers. Except as provided below and in Ch. 8.03 (relating to cash accounting), farmers would not be required to keep inventories for tax purposes if not currently required to do so. With respect to preproductive period expenses, the rules of section 447 would continue to apply to the taxpayers currently covered by that provision (except in the case of property subject to section 278, revised as described below). Section 278, which deals with the capitalization of the development costs of fruit and nut orchards and vineyards, would be revised and extended to apply generally to any plant or animal, other than animals held for slaughter, whose preproductive period was two years or longer. The new provision would apply to all taxpayers, not just farming syndicates. In the case of plants, the preproductive period would begin with the time the plant or seed was first planted or acquired by the taxpayer, and would end with the time that the plant became productive or was disposed of. For example, in the case of a taxpayer developing an orchard, the preproductive period would begin with the time the seedlings or saplings were purchased by the taxpayer, and would end with the time the tree first bore fruit. In the case of animals, the preproductive period would begin at the time of breeding or embryo implantation (or at the time the taxpayer first acquired the animal), and would end when the animal became productive or was disposed of. An animal would be treated as productive when ready to perform its intended function, for example, when ready to be bred or to produce marketable quantities of milk. Animals held for slaughter would not be subject to these rules. If the preproductive period were two or more years long, the preproductive period expenses would have to be capitalized. The types of expenses that must be capitalized would be defined comprehensively as above. However, in lieu of capitalizing such expenses, taxpayers would be permitted to use inventory valuation methods such as the farm-price or unit-livestock-price method.

Capitalization of construction-period interest. Construction-period interest would have to be capitalized in the case of self-constructed property with a long useful life, and in the case of any property with a production period of two years or longer. With respect to self-constructed property, construction-period interest would have to be capitalized if it relates to property included in

CCRS Class 5, 6, or 7. In determining whether the production period is two years or longer, the period would generally begin with the commencement of construction or production and end with the time when the property is ready to be placed in service or held for sale. In the case of property produced under a long-term contract, the production period would end with contract completion. Interest attributable to the raising of plants or animals with a preproductive period of two years or longer would also have to be capitalized. The interest capitalization rule, however, would not apply to self-constructed assets to be used by the taxpayer for personal purposes (such as residential real estate).

Construction-period interest would be defined as any interest expense of the taxpayer that would have been avoided if production or construction expenditures had been used to repay indebtedness. Production or construction expenditures would be defined as equal to the cumulative production costs required to be capitalized. In effect, as under current-law rules defining construction-period interest, the taxpayer's interest cost would be deemed first allocable to production or construction activities. Indebtedness incurred specifically to finance construction would first be allocated to such construction. If construction-period expenditures exceed the amount of debt so allocated, interest on other debt of the taxpayer in the amount of such excess would be treated as construction-period interest. Where the taxpayer has outstanding debt with different rates of interest, the construction-period interest (other than interest specifically allocated to construction) would be computed according to the average interest rate on the taxpayer's debt. Appropriate related-party rules would be provided.

A customer of a contractor making progress payments or advance payments would be treated as self-constructing the property under construction by the contractor to the extent of such payments. Thus, payments and other advances by a customer would be treated as the customer's construction or production expenditures, and the contractor's construction or production expenditures would be reduced to this extent. The customer would have to capitalize interest attributable to such payments if the constructed property were in CCRS Class 5, 6, or 7, or if the construction period were two years or longer. To the extent of such advances by the customer, the contractor would not be treated as having incurred construction expenses, and would accordingly not have to capitalize construction-period interest. The contractor would have to capitalize construction-period interest on only the excess, if any, of its accumulated contract costs over the accumulated advances or progress payments it received.

In cases where interest is required to be capitalized, the interest would be added to the basis of the property being constructed. The basis of such property would be eligible for indexing, under rules similar to those set forth in Chapter 7.01, during the production period and thereafter. In the case of a

contractor, contract costs up to the amount of advance payments made by the customer would not be eligible for indexing as far as the contractor is concerned, but would be treated as self-construction by the customer and eligible for indexing in the customer's hands.

Effective Date

Except as provided below, the proposed rules concerning production cost accounting and the capitalization of interest would be effective generally for costs and interest expense paid or incurred on or after January 1, 1986. The new rules would not apply to long-term contracts entered into before 1986. Production costs (including interest) attributable to timber that was planted before 1986 that are not required to be capitalized under present law would have to be capitalized under a ten-year phase-in. Thus, 10 percent of such costs paid or incurred in 1986 and 20 percent of such costs paid or incurred in 1987, etc., would have to be capitalized, until 100 percent was capitalized in 1995.

With respect to inventories, the new rules would apply for the taxpayer's first taxable year beginning on or after January 1, 1986. In order to minimize large distortions in taxable income, taxpayers subject to the new inventory cost accounting rules would be allowed to spread the adjustment that results from changing to the new method of accounting for production costs ratably over a period not to exceed six taxable years. This spread is in accordance with the usual rules for a change in method of accounting initiated by the taxpayer and approved by the Internal Revenue Service.

Finally, the new rules would not apply to self-constructed assets where substantial construction had begun before 1986.

Analysis

Capitalization of production costs means that instead of being currently deductible, the costs are recovered when the produced property is sold or through depreciation, amortization or depletion deductions as the property is used in the taxpayer's business. When capital costs are not capitalized, deductible expenses are accelerated instead of being matched with the receipt of the taxable income they serve to produce. The acceleration of expenses allows other income to be sheltered by the deductions, and taxable income is correspondingly deferred until later years. The deferral of tax liability in this manner is the equivalent of the taxpayer receiving a subsidy, in the form of an interest-free loan from the Federal government.

Interest expense is a significant component of long-term production costs that generally is not required to be capitalized under current law. Because interest expense is a small portion of the total expenses incurred in short-term production activity, the

proposal would generally require capitalization of interest only where production takes several years. Interest incurred in relatively short-term production of long-lived self-constructed assets would have to be capitalized, however, since a current deduction for such costs significantly accelerates deductions in comparison with capitalization. Because money is fungible, it is necessary to make certain assumptions as to the amount of interest attributable to production activities. Under the proposal, any debt outstanding would be attributed first to construction costs associated with the long-term production activity. The same rule applies in defining construction-period interest under current law.

Uniform rules for the capitalization of production costs would make the tax code more neutral in its application to various business activities. Uniform rules would also place all long-term production activities on a consistent tax accounting basis, and reduce tax-induced distortions in constructing and acquiring capital assets.

Special rules would recognize the special circumstances of certain industries. Thus, the current rules that do not require farmers to use inventories in computing income with respect to most crops would be retained, except as provided in Ch. 8.03, so as not to impose an undue recordkeeping burden. In the case of certain plants and animals that take a long time to mature, however, production costs would have to be capitalized, to avoid a significant deferral of tax liability.

The special rule requiring certain Federal contractors and cost-plus contractors to capitalize general and administrative expenses is appropriate because these contractors are paid for such overhead costs as part of the contract price. While it is generally not an easy matter to determine what portion of business overhead is properly allocable to a contract, the determination is not difficult where a contractor directly bills the customer for the overhead or relies on the allocated overhead in setting the contract price. Current law allows such contractors to be paid for overhead costs under the contract, but to treat such costs for tax purposes as period costs unrelated to the contract. Allowance of a current deduction for such costs defers tax by allowing a deduction in advance of recognition of the income to which it relates. The proposal would put Federal tax accounting on a consistent basis with contract cost accounting. The generosity of current accounting rules effectively subsidizes Federal government contracts, causing the actual cost of such contracts to the government to be understated. The budgetary process would be improved if this subsidy were removed and the full costs reflected in government outlays.

RECOGNIZE GAIN ON PLEDGES OF INSTALLMENT OBLIGATIONS

General Explanation

Chapter 8.02

Current Law

Income from an installment sale is reported as payments are received, rather than in the year of sale, unless the taxpayer elects otherwise. In general, an installment sale is a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. The gain recognized for any taxable year is the proportion of the installment payments received in that year which the gross profit to be realized when payment is completed bears to the total contract price ("gross profit ratio"). In general, the total contract price is the principal amount that will be paid to the seller. Treasury regulations provide analogous rules for installment method reporting by dealers in personal property.

Any indebtedness assumed by the buyer which is not "qualifying indebtedness" is treated as a payment in the year of sale or disposition. Qualifying indebtedness is treated as a payment in the year of sale only to the extent that it exceeds the seller's basis in the property. The term qualifying indebtedness means (1) a mortgage or other indebtedness encumbering the property, and (2) indebtedness incurred or assumed by the seller incident to the seller's acquisition, holding, or operation of the property in the ordinary course of business or investment.

If the seller disposes of an installment obligation, the tax that has been deferred on the installment sale generally becomes due. However, if a taxpayer pledges an installment obligation as collateral for a loan, he may, under some circumstances, continue to defer his tax on the sale.

Reasons for Change

The installment method was intended to alleviate liquidity problems that might arise if a taxpayer was required to pay tax on a sale when he had not received all or a portion of the sales proceeds. Nevertheless, under certain circumstances current law permits a taxpayer to defer his tax liability on an installment sale even though he has obtained cash by using the installment note as collateral for a loan. For example, assume that a taxpayer sells property for $100,000, payable in ten years with market-rate interest payable annually, and pledges the note as collateral for a loan of $90,000 from a bank. The interest payments received from the buyer on the installment obligation provide the taxpayer with funds to make

interest payments on the $90,000 loan from the bank. Although the taxpayer has the use of $90,000 for ten years, current law permits him to defer tax on his gain from the sale until receipt of payment from the buyer in ten years. Moreover, such deferral may be permitted even if the buyer's note is secured by a bank letter of credit, so that the transaction is essentially riskless for the seller. In such circumstances, the taxpayer obtains the benefit of the profit element on the sale and has sufficient cash to pay the tax liability. There is no reason to permit such a taxpayer to continue to defer tax liability on the sale.

If instead of pledging the installment note after the sale of the property, the taxpayer had pledged the property for a loan prior to the sale and the buyer had assumed the taxpayer's indebtedness, the amount of the indebtedness (in the case of qualifying indebtedness, the excess over basis) would have been treated as a payment in the year of sale. Similar rules should apply regardless of whether the indebtedness is incurred before or after the sale.

Proposal

In general, the pledge of an installment obligation as security for a loan would cause recognition of all or a portion of the gain remaining to be recognized by the taxpayer with respect to the installment obligation. The following rules would control the recognition of such gain: In the case of an amount borrowed in the ordinary course of business and secured by an installment obligation received for the sale of property held by the taxpayer primarily for sale to customers within the ordinary course of business, gain on the installment obligation would be recognized to the extent of the excess of the amount borrowed over the basis of the obligation. In all other cases, gain on the installment obligation would be recognized to the extent of the amount borrowed (and secured by the installment obligation) multiplied by the gross profit ratio. Gain from an installment obligation which, but for this rule, would be recognized on subsequent payments on the obligation would be offset against the gain generated by the use of the installment obligation as security for indebtedness. Thus, in no case would the aggregate gain recognized by the taxpayer with respect to the installment obligation exceed the taxpayer's gross profit with respect to the installment obligation.

Exceptions would be provided for: an installment obligation which by its terms requires payment in full within a period not exceeding one year and which is received for the sale of property held by the taxpayer primarily for sale to customers in the ordinary course of business; a revolving credit plan which, by its terms and conditions, contemplates that all charges for each sale will be paid within a period not exceeding one year from the date of purchase; any indebtedness which by its terms requires payment in full within a period not exceeding 90 days from the date of issue, and which is not renewed or continued; and certain indebtedness owed to a financial institution and secured by a general lien on all of the borrower's

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trade or business assets. The general lien exception would not apply to a case, such as a financing subsidiary, where substantially all the borrower's assets are installment obligations.

Effective Date

The proposal would be effective for installment obligations pledged as security on or after January 1, 1986. In addition, any indebtedness outstanding on January 1, 1991 which is secured by an installment obligation which was pledged as collateral prior to January 1, 1986 would be treated as if the installment obligation was pledged on January 1, 1991.

Analysis

As shown in Table 1, the deferral of tax liability under the installment method can substantially reduce a taxpayer's effective tax rate. For example, when interest rates are eight percent, the deferral of tax for ten years by a taxpayer with a marginal tax rate of 50 percent reduces the effective tax rate to 23 percent. In effect, under the installment method, the Federal government makes an interest-free loan to the taxpayer of the tax that otherwise would be due in the year of sale. The benefit of tax deferral under the installment method would be denied to taxpayers who have obtained cash by pledging an installment obligation.

In recent years, builders of commercial and residential real estate and sellers of equipment have issued bonds and debentures secured by their installment receivables. The volume of such borrowing by home builders alone has grown rapidly and is estimated to have exceeded $5 billion in 1984. The proposal would somewhat reduce the tax benefits of such transactions. To the extent that the proceeds from the bond or debenture exceed the taxpayer's basis in the installment obligations used as security, the taxpayer would recognize deferred gain from the installment sales. In such cases, the borrowing represents enjoyment of the profit element from the installment sales and should trigger recognition of income.

Certain dealers in personal property also have taken advantage of the ability to borrow against installment receivables by employing a single-purpose financing subsidiary, which has few assets other than installment obligations and incurs debt secured by a general lien on its assets. These transactions would be affected by the proposal unless they are within the exception for installment obligations with a term of one year or less, or the exception for certain revolving credit plans.

Finally, individual taxpayers have used installment obligations as security for indebtedness incurred for personal expenses. The proposal would eliminate the tax benefits of such transactions.

Table 8.02-1

Effective Tax Rate Per Dollar of Income Deferred by a 50 Percent Taxpayer for Different Deferral Periods and Interest Rates

Interest Rate	Deferral Period (in years)					
	1	3	5	10	20	30
4 percent	48.1	44.4	41.1	33.8	22.8	15.4
6 percent	47.2	41.0	37.4	27.9	15.6	8.7
8 percent	46.3	39.7	34.0	23.2	10.7	5.0
10 percent	45.4	37.6	31.0	19.3	7.4	2.9
12 percent	44.6	35.6	28.4	16.1	5.2	1.7

Office of the Secretary of the Treasury May 28, 1985

LIMIT USE OF CASH METHOD OF ACCOUNTING

General Explanation

Chapter 8.03

Current Law

The Internal Revenue Code provides for the following permissible methods of accounting: (1) the cash receipts and disbursements method ("cash method"), (2) an accrual method, or (3) any other method or combination of methods permitted under Treasury regulations. A taxpayer is entitled to adopt any one of the permissible methods for each separate trade or business of the taxpayer, provided that the method selected clearly reflects the taxpayer's income from such trade or business. A method of accounting that reflects the consistent application of generally accepted accounting principles ordinarily is considered to clearly reflect income.

The cash method of accounting generally requires an item to be included in income when actually or constructively received and permits a deduction for an expense when paid. In contrast, the principles of the accrual method of accounting generally require that an item be included in income when all the events have occurred which fix the right to its receipt and its amount can be determined with reasonable accuracy. Similarly, a deduction is allowed to an accrual basis taxpayer when all events have occurred which determine the fact of liability for payment, the amount of the liability can be determined with reasonable accuracy, and the economic performance that establishes the liability has occurred.

In general, taxpayers that are required to use inventories for a particular trade or business (other than farming) must use an accrual method of accounting for their purchases and sales. A taxpayer is required to use inventories in all cases in which the production, purchase, or sale of merchandise is an income-producing factor. Any other permissible method of accounting (including the cash method) may be used for other purposes in that trade or business or for other trades or businesses of the taxpayer.

A person engaged in the trade or business of farming generally may use the cash method of accounting for such business even though the farming business may involve the production and sale of goods. Use of the accrual method is required, however, for a corporation (other than S corporations and certain family-owned corporations) engaged in the trade or business of farming (or a partnership engaged in the trade or business of farming that has a corporation as a partner) that has gross receipts of more than $1 million in any taxable year beginning after December 31, 1975.

Reason for Change

The cash method of accounting frequently fails to reflect the economic results of a taxpayer's business over a taxable year. The cash method simply reflects actual cash receipts and disbursements, which need not be related to economic income. Obligations to pay and rights to receive payment are disregarded under the cash method, even though they directly bear on whether the business has generated an economic profit or a loss. Because of its inadequacies, the cash method of accounting is not considered to be in accord with generally accepted accounting principles and, therefore, is not permissible for financial accounting purposes.

The relative simplicity of the cash method justifies its use for tax purposes by smaller, less sophisticated businesses, for which accrual accounting may be burdensome. Current law, however, permits many taxpayers that already use an accrual method for financial accounting purposes to use the cash method for tax purposes.

The cash method also produces a mismatching of income and deductions where the taxpayer engages in transactions with parties that employ a different method of accounting. For example, an accrual method taxpayer may deduct certain liabilities as incurred (even though not yet billed), such as liabilities for certain services rendered, even though the service provider on the cash method may defer reporting income until the amount is billed and cash payment thereon is made.

Proposal

A taxpayer would not be permitted to use the cash method of accounting for a trade or business unless it satisfied both of the following conditions: (1) the business has average (determined on a 3-year moving average basis) annual gross receipts of $5 million or less (taking into account appropriate aggregation rules); and (2) with respect to a trade or business other than farming, no other method of accounting has been used regularly to ascertain the income, profit, or loss of the business for the purpose of reports or statements to shareholders, partners, other proprietors, beneficiaries or for credit purposes. Consideration will also be given to taking into account the billing of clients for services in the use of the accrual method.

The above conditions would apply in addition to the current law limitation on use of the cash method with respect to a trade or business in which inventory accounting is required. The current rules requiring certain corporations to use accrual accounting for the trade or business of farming would also remain in effect in addition to the above rules.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986. In order to minimize large distortions in the taxable income of taxpayers who are required to change from the cash to the accrual method, the administrative rules generally applicable to changes in methods of accounting initiated by the taxpayer and approved by the Internal Revenue Service would be applied. Accordingly, taxpayers affected by the proposal would be allowed to spread the adjustment that results from the difference between the use of the cash and accrual methods of accounting ratably over a period not to exceed six taxable years.

Analysis

The proposed restriction on the use of the cash method of accounting would affect only a small percentage of firms. In 1981, approximately 103,000 corporations (eight percent of all corporations), 4,000 partnerships (one percent of all partnerships), and 1,800 sole proprietorships (including about 300 farmers) (less than one percent of all sole proprietorships) had receipts greater than the proposed $5 million limitation. Some of these businesses already use the accrual method of accounting for tax purposes. Accurate measurement of the income of these large firms is important to the integrity of the tax system, since they account for a significant share of business receipts.

The proposal would affect only businesses that are already using an accrual method of accounting in some part of their business or are sufficiently large to have access to professional accounting expertise. The primary industries that would be affected by the proposal would be banks that use an accrual method of accounting for financial reporting and large service organizations, such as accounting, law and advertising firms.

The virtue of the cash method's simplicity would be retained for those businesses, such as small farmers, that might be unduly burdened by a requirement that they use accrual accounting.

REPEAL RESERVE METHOD FOR BAD DEBT DEDUCTIONS

General Explanation

Chapter 8.04

Current Law

Taxpayers may deduct a business bad debt in the year in which it becomes worthless or, in the case of partially worthless debts, in the year in which part of the debt is charged off. In lieu of deducting specific bad debts, both cash and accrual method taxpayers may create a bad debt reserve for the obligations created or acquired in the course of a trade or business and held by the taxpayer at the close of the taxable year. In any year, the taxpayer may deduct an addition to the reserve sufficient to bring it to a reasonable level. The purpose of the reasonable reserve is to estimate the portion of the obligations held by the taxpayer at year-end that will become uncollectible in the future. Debts that become worthless during the year are charged against the reserve. This charge reduces the reserve and hence increases the amount that must be added to the reserve to restore it to an appropriate level. The deduction for additions to a bad debt reserve effectively allows a deduction for debts that become worthless during the year plus a deduction for future bad debts (attributable to the increase in the amount of receivables held at year-end).

A dealer in property may deduct a reasonable addition to a reserve for bad debts relating to its liability as a guarantor of debt obligations arising out of the sale by the taxpayer of property in the ordinary course of its trade or business. In the case of certain taxpayers who were in existence in 1965, a suspense account arrangement prevents allowance of a double deduction by reason of a change in law which took place at that time.

Special rules govern the tax treatment of bad debts of depository institutions; these rules are dealt with in Ch. 10.01.

Reasons for Change

The reserve method for bad debt deductions allows taxpayers to deduct the bad debt losses in the current year and to deduct any net increase in the reserve. The deduction for the increase in the reserve represents a deduction for estimated future loan losses arising from an increase in the level of receivables on hand, without any discount for the present value of such losses. Moreover, the formula used to estimate such losses bears no necessary relationship to the future losses. The accelerated deduction for future losses defers taxable income and thereby reduces the effective tax rate of a business which experiences an increasing bad debt reserve.

In addition to distorting the timing of taxable income, the reserve method of accounting for bad debt deductions discriminates in favor of firms with growing accounts receivable or worsening loss experiences. In contrast, firms that have improved loss experiences or declining loan portfolios will be taxed on the deferred taxable income.

Finally, the preferential tax treatment of bad debt reserves reduces the effective tax rate on the compensation earned by lenders for bearing the risk of loan default and enables lenders to lower the risk premium charged. Thus, the tax system encourages lenders to make risky loans. By lowering the interest rate charged on risky loans, the preferential tax treatment also distorts the choice between debt and equity financing for projects involving some risk of default.

Proposal

The deduction for a reasonable addition to a reserve for bad debts would be repealed, although taxpayers would continue to be entitled to a deduction for debts that become worthless or are partially charged off. This proposal would also apply to the bad debts of financial institutions governed by Subchapter H.

The deduction for bad debts that become worthless would be conformed to the deduction for partially worthless debts. Thus, a deduction would not be allowed until a debt is charged off in whole or in part.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986. In order to prevent a double deduction for debts that become partially or wholly worthless after the effective date, a taxpayer's outstanding bad debt reserve at the close of the taxable year prior to the effective date would be includable in income ratably over a 10-year period.

Analysis

Taxpayers are generally not allowed to deduct future liabilities or losses until they occur. Because no market transaction occurs to fix the amount and timing of the loss for worthless or partially worthless debts, the most accurate method to determine the appropriate deduction for bad debts in a taxable year is to judge the loss that has occurred by examining the loan portfolio at the close of the year, based on all the facts known at that time.

In the contrast, any reserve system, even one based on generally accepted accounting principles, is based to some degree on expectations as to future losses. Such an ex ante approach would be inconsistent with the general principle that only realized losses are deductible. If reserves for future losses were allowed, a neutral tax

reserve system would limit the deduction to the estimated present value of the future loss. Such a system would also require any divergences from the assumptions used in the present value calculation to be corrected. An accurate reserve system is not proposed because of the extreme administrative complexity that it would entail.

To illustrate the deferral allowed by the current reserve system, suppose a new firm, shown in Table 1, begins with $1,000 of accounts receivable and in the first year has $10 of bad debts (an experience rate of one percent). Under a reserve system where the allowable reserve equals the current year losses, the firm establishes a year-end reserve of $10. The allowable first year bad debt deduction is $20 -- $10 of actual losses plus $10 for the increase in the allowable reserve. As long as the firm's loss experience does not improve and its level of receivables does not decrease, the excess deduction is deferred indefinitely. If the firm prospers and accounts receivable increase in year two to $1,500 with the same loss experience rate of one percent, the allowable reserve increases to $15 and the company deducts $20 -- $5 more than the actual loan losses. In year three, if loans remain the same but the loss experience worsens to two percent, the company can deduct $45. Finally, if in the fourth year the company experiences a decrease in accounts receivable, its bad debt deduction is less than the loan losses that actually occurred. A net decrease in the bad debt reserve effectively brings excess deductions back into taxable income, thereby ending tax deferral on that amount. Table 1 in Ch. 8.02 shows the reduction in effective tax rate due to tax deferral for given deferral periods and interest rates.

Table 2 shows the discrepancy between bad debt deductions and actual loan losses due to the reserve method. The overstatement of losses and the amount of tax deferral depends on the growth rate of loans and the change in the loss experience rate. Credit growth over the past 10 years for domestic non-financial corporations was in excess of 20 percent annually. The change in the loss experience rate is not known, and is probably cyclical. Yet even with a constant loss rate, bad debt deductions overstated aggregate actual loan losses by 10 percent annually.

The modification of the rule governing when a worthless bad debt may be deducted would give taxpayers flexibility and would avoid penalizing them for failing to deduct a bad debt in the year in which it became worthless.

Table 8.04-1

Hypothetical Example of Excess Deductions with Reserve Method

	Year			
	1	2	3	4
Loss experience rate (percent)	1.0	1.0	2.0	2.0
Total loans or receivables	$1,000	$1,500	$1,500	$1,000
Actual losses	10	15	30	20
Beginning reserve	0	10	15	30
End reserve	10	15	30	20
Change in reserve	10	5	15	-10
Bad debt deduction [Losses plus change in reserve]	20	20	45	10
Excess deduction [Deduction minus actual losses]	10	5	15	-10
Accumulated excess deductions	10	15	30	20

Office of the Secretary of the Treasury May 28, 1985

Table 8.04-2

Discrepancy Between Reserve Deductions 1/ and Actual Bad Debt Losses By Change in Total Loans and Loss Experience

(In Percent)

Annual Percentage Change in Loss Experience	Annual Percentage Change in Total Loans					
	-5	0	+5	+10	+15	+20
- 5	-11.2	-4.9	-0.2	3.3	6.0	8.0
0	-4.9	0.0	3.6	6.3	8.4	10.0
+ 5	-0.2	3.6	6.4	8.6	10.2	11.4
+10	3.3	6.3	8.6	10.2	11.5	12.5
+15	6.0	8.4	10.2	11.5	12.5	13.3

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1/ Assumes a six-year moving average experience method reserve. Shorter periods increase the discrepancy.

REPEAL MINING AND SOLID WASTE RECLAMATION AND CLOSING COST DEDUCTION

General Explanation

Chapter 8.05

Current Law

Expenses that will be incurred in the future cannot generally be deducted currently, even if the existence of the liability can be established with certainty. As a general rule, taxpayers using the cash method of accounting may deduct future expenses only when payment is made. Taxpayers using the accrual method of accounting generally may deduct future expenses only when the economic performance or activity giving rise to the expense has occurred. However, pursuant to a statutory exception to the economic performance requirement, taxpayers may take current deductions associated with certain mining and solid waste disposal site reclamation and closing costs. The amount that may be deducted in any year generally is the estimated future reclamation or closing costs attributable to production or mining activity during the taxable year. The estimate must be made on the basis of reclamation and closing cost prices prevailing in the taxable year. To obtain the deduction, no amount need be placed into a fund, but deducted amounts are added to a bookkeeping reserve maintained for tax purposes. In addition, interest on the additions to the reserve must be added to the reserve each year at a rate specified in the statute. When reclamation or closing occurs, the balance in the reserve is compared to the actual cost of closing or reclamation. If the total amount in the reserve, including interest, exceeds the reclamation or closing costs, further deductions are not allowed and the excess must be included in income. Amounts spent on reclamation or closing costs are charged against the reserve, and are deductible only to the extent the reserve is exhausted.

Expenses subject to the above rules include generally any expenses for land reclamation or closing activity pursuant to a reclamation plan under the Surface Mining Control and Reclamation Act of 1977 or similar law. Also included are expenses incurred for any land reclamation or closing activity in connection with any solid waste disposal site conducted in accordance with the Solid Waste Disposal Act or other similar law. Expenses attributable to property which is disturbed after being listed in the national contingency plan established under the Comprehensive Environmental, Compensation, and Liability Act of 1980 are not, however, included.

Reasons for Change

The special rules for strip mining and waste disposal closing and reclamation costs allow a current deduction for future costs without recognition of the fact that economic performance will occur, and the

cost will be paid, in the future. The requirements to increase the reserve by an interest charge and to recapture reserves limit the extent to which the present value of the reserve is overstated. Nevertheless, the deduction generally is overstated in real terms and results in a reduced effective tax rate for those companies that find the special tax treatment to be advantageous for them.

The preferential tax treatment reduces the production costs of companies engaged in surface mining and companies generating solid waste. By reducing the costs of the products of these companies, the tax system encourages production processes that cause environmental damage. Regulations already in place require the environmental damage to be corrected. The tax system should not be employed to subsidize the costs of compliance. Such costs generally should be borne (through higher product prices) by the users of the products whose production damages the environment, rather than by all taxpayers. If it is determined that certain of these costs are of such societal importance as to justify a Federal subsidy, that subsidy should be provided through the appropriations process, not the tax system.

The current reserve system is substantially more complicated than a system requiring deduction of the future expenses when they occur. Future expenses must be estimated; records must be kept of previously deducted amounts; interest must be imputed on this amount on a cumulative basis; and excess amounts in the account must be recaptured, requiring a re-estimate of future costs each year. Further, as reclamation or closing costs are incurred, the costs must be allocated to particular properties, since reclamation and closing can be taking place on several sites at the same time.

Proposal

The special rules for mining and solid waste disposal reclamation and closing costs would be repealed. Accordingly, such costs would generally be deductible only as the sites were closed or the land reclaimed.

Effective Date

The proposal would be effective for mining or production activity occurring on or after January 1, 1986.

Analysis

The proposal would eliminate the indirect Federal subsidy for mining and solid waste reclamation and disposal costs. Under existing law, companies are allowed to accelerate deductions for future expenses, thus reducing their effective tax rates through tax deferral. This preferential tax treatment reduces the costs of companies incurring such expenses. The elimination of the tax preference can be expected to raise by a small amount the price of the affected products, which for the most part involve production processes that cause environmental damage. A small shift in consumption away from such products would result.